

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FS:LI:POSTF-145712-02
TKerrigan

date: December 17, 2002

to: Territory Manager
Attention: Group 1347-LMSB

from: Associate Area Counsel
CC:LM:FS:LI

subject: [REDACTED] - Royalty Buyout
EIN: [REDACTED]
Taxable year [REDACTED]
U.I.L. No. 0483.00-00

This memorandum responds to a request for assistance from Cathy Rich of your staff concerning the taxpayer's royalty buyout payment whereby the company purchased the right to receive royalty payments with respect to domestic sales made under the [REDACTED] brand from the [REDACTED] trust. This memorandum should not be cited as precedent.

FACTS

The relevant facts, as we understand them to be, are as follows: On [REDACTED], the taxpayer entered into an agreement with [REDACTED], the [REDACTED], acquiring the "[REDACTED]" trademark and dependent trademarks from [REDACTED]. In [REDACTED], [REDACTED] had registered and was granted a United States trademark [REDACTED]. The agreement provided that in exchange for the trademarks [REDACTED] was to receive [REDACTED]% of net sales on the domestic and international sales of [REDACTED] brand products during [REDACTED] lifetime. Since the sale was on a deferred payment basis, the agreement further provided that part of each deferred royalty payment represented interest. The stated interest rate was [REDACTED]% per annum with principal and interest calculated in accordance with Treas. Reg. § 1.483-1(g) of the 1954 Internal Revenue Code.

20423

During the taxpayer's examination for the fiscal years [REDACTED]-[REDACTED], the Service challenged the sales price for the domestic trademarks set forth in the [REDACTED] agreement on the ground that at least a part of [REDACTED]'s economic interest in the trademarks were previously transferred to the taxpayer. The issue was ultimately resolved at Appeals on [REDACTED] [REDACTED] with the parties agreeing that [REDACTED]% of the [REDACTED]% (i.e. [REDACTED]%) paid to [REDACTED] constituted payment for the acquisition of the trademarks. The remaining balance (i.e. [REDACTED]%) of the royalty payment would be treated as dividend payment for Federal tax purposes.

From [REDACTED] through [REDACTED], the taxpayer elected to deduct the payments made to [REDACTED] as an I.R.C. § 162 trade or business expense pursuant to I.R.C. § 1253(d)(1).^{1/} Beginning in [REDACTED], the taxpayer was no longer able to claim a deduction for the full amount of payments made on account of the acquisition of the trademarks. The taxpayer's claimed deduction was then limited to that portion of the deferred payments representing interest.

In [REDACTED], [REDACTED] transferred [REDACTED] rights to payments under the agreement with respect to domestic sales to [REDACTED]. In [REDACTED], in anticipation of its initial public offering, the taxpayer purchased the rights from the trust for \$[REDACTED]. The taxpayer hired an actuary who determined the life expectancy of [REDACTED], calculated the remaining value of the payments due to [REDACTED] using a [REDACTED]% royalty rate and discounted the total payment amount to present value. Consistent with the terms of the [REDACTED] agreement, the taxpayer allocated \$[REDACTED] of the buyout purchase price to principal and \$[REDACTED] to interest using a factor of [REDACTED], which was calculated by using the

^{1/} I.R.C. § 1253(d)(1) provides that amounts paid or accrued during the taxable year on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name which are contingent on the productivity, use, or other disposition of the franchise, trademark, or trade name transferred shall be allowed as a deduction under I.R.C. § 162(a). § 516(d)(3) of the Tax Reform Act of 1969, P.L. 91-172, 1969-3 C.B. 104, provides that I.R.C. § 1253 shall apply to transfers after December 31, 1969, except that I.R.C. § 1253(d)(1) shall, at the election of the taxpayer, apply to transfers before January 1, 1970, but only with respect to payments made in taxable years ending after December 31, 1969, and beginning before January 1, 1980.

applicable factor for payments deferred for more than [REDACTED] but less than [REDACTED] months as set forth in Table I - Present Value of Deferred Payment under Treas. Reg. § 1.483-1(g).

ISSUE

Whether the taxpayer is entitled to an interest expense deduction in the amount \$[REDACTED] resulting from the royalty buyout payment for the acquisition of the "[REDACTED]" trademark and dependent trademarks?

LEGAL ANALYSIS

I.R.C. § 483 provides, in general, that in the case of a sale or exchange of property under a contract where payments are deferred more than one year after the date of the sale or exchange and no interest or inadequate interest is stated, then a portion of the deferred payments represents "total unstated interest" and is to be treated as interest rather than part of the sale or exchange price. Under Treas. Reg. § 1.483-1(d)(2), the imputed interest provisions will not apply to deferred contracts where as in this case the contract provides for interest at a rate of at least 4% simple interest per annum, payable on each installment of principal at the time such installment is payable.

I.R.C. § 163(a) provides that there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness. Treas. Reg. § 1.461-1(a)(2) provides, in relevant part, that for accrual method taxpayers, an expense is deductible for the taxable year in which all the events have occurred which determined the fact of the liability and the amount thereof can be determined with reasonable accuracy. Accordingly, [REDACTED]% per annum, computed from the date of the agreement of the royalty buyout deferred payment is properly treated as interest within the meaning of I.R.C. § 163.

The remaining issue is whether the taxpayer properly computed its interest expense deduction. It appears that the actuarial calculation of the net present value of the future royalty payments owed to [REDACTED] used the [REDACTED]% royalty rate per the original agreement instead of the adjusted royalty rate of [REDACTED]%. Therefore, the remaining [REDACTED]%, re-characterized as dividend income to [REDACTED] would not

qualify as an I.R.C. § 483 deferred payment requiring a present value computation for purposes of determining principal and deductible interest.

CONCLUSION

Based on the information provided, the interest deduction is likely overstated and needs to be recalculated using a royalty rate of [REDACTED]%. This opinion is based upon the facts set forth herein. It might change if the facts are determined to be incorrect. If the facts are determined to be incorrect, this opinion should not be relied upon.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions or require further assistance, please contact Thomas Kerrigan at (516) 688-1742.

ROLAND BARRAL
Area Counsel

By: _____
JODY TANCER
Associate Area Counsel